ST 00-22
Tax Type: Sales
Issue: Reasonable Cause on Application of Penalties

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS v. **ABC TELECOMMUNICATIONS, INC.,** Taxpayer	No. Christine O'Donoghue Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: Mr. Mark Dyckman, Special Assistant Attorney General for the Illinois Department of Revenue; Mr. John B. Truskowski, Lord, Bissell & Brook for ABC Telecommunications, Inc.

Synopsis:

This matter comes on pursuant to ABC Telecommunication Inc.'s (hereinafter "taxpayer" or "ATI") timely protest of two Notices of Tax Liability ("NTL") issued for the periods of July 1, 1993 through November 30, 1993 and December 1, 1993 through December 31, 1996, respectively, and a Notice of Tentative Denial of Claim issued on October 7, 1998, covering the identical period. The issues identified by the parties in the pre-hearing order are: 1) whether ATI is a contractor under Section 1 of the Act and, therefore, owes use tax as stated on the NTLs 2) whether the taxpayer is entitled to a

refund of retailers' occupation tax ("ROT") and 3) whether the penalties should be abated due to reasonable cause. In its post-hearing memorandum of law, taxpayer conceded that it owes the use tax on the cost of the materials used in its contracting business which is the basis of the liability stated on the Notices of Tax Liability, (Taxpayer Brief p. 5), thus, only issues number #2, and #3 need be addressed in this recommendation for disposition.

After consideration of the evidence and the briefs filed herein, it is my recommendation that the Tentative Denial of Claim should be finalized. The Notices of Tax Liability assessing use tax should be finalized as a result of taxpayer's concession, however, I recommend that the penalties be abated due to reasonable cause.

Findings of Fact:

1. The Department established its *prima facie* case, inclusive of all jurisdictional elements, by the introduction of correction of returns for the period of July 1, 1993 through November 30, 1993 in the amount of $51,363.00 of tax and $5,136.00 in penalties with accruing statutory interest. The second correction of return was issued for the period of December 1, 1993 through December 31, 1996 in the amount of $380,085.00 of tax and $57,013.00 of late payment penalties with accruing statutory interest. Dept. Ex. No. 1.
2. The Department's *prima facie* case was also established by the introduction of the Notice of Tentative Denial of Claim for the period of July 1, 1993 through December 31, 1996, denying taxpayer's claim for credit in the amount of $869,832.00. Dept. Ex. No. 1.
3. ABC Telecommunications, Inc. installs and services telephone equipment and voice mail systems. Tr. p. 15.

4. JOHN DOE is the general manager of ATI. He has worked at ATI since May of 1993. Tr. p. 14.

5. DOE was the Department auditor's main contact during the Department audit. Tr. p. 15.

6. When contracting to install voice mail systems, the taxpayer and its customer used a two-page contract. Dept. Ex. No. 7; Taxpayer Ex. No. 1.

7. The contract contained language that stated it is the complete and exclusive agreement between the parties. Dept. Ex. No. 7; Section 14.

8. The contract is silent regarding the payment of taxes. Dept. Ex. No. 7.

9. The contract does not detail the amount charged for labor or materials. Tr. pp. 19, 20.

10. ATI filed sales and use tax returns during the audit period. On these tax returns, the taxpayer stated gross receipts on line 1 and took a deduction for tax collected. Taxpayer also calculated and took the discount for timely filing the tax return and remitting ROT. Dept. Ex. Nos. 2, 5, 6 (Schedule of Sales per Books and Records & Schedule of Returns as Filed).

11. DOE signed the monthly sales and use tax returns filed for the periods at issue. Tr. p. 38.

12. The taxpayer also made accelerated ROT payments during the audit period. Dept. Ex. Nos. 5 & 6; Tr. p. 41.

13. During the audit, the auditor determined that the taxpayer was recording tax collections in its books and records. Dept. Ex. No. 2.

14. The auditor prepared the Schedule of Sales per Books and Records based upon her review of the taxpayer's workpapers. Tr. p. 40.

15. The auditor prepared the Schedule of Returns as Filed based upon her review of the sales tax returns given to her by the taxpayer. Tr. p. 40.

16. The Department auditor determined that ATI collected and remitted ROT from its customers during the period at issue. Tr. p. 41. She based her determination upon a review of taxpayer's books and records, including contracts, sales and purchase invoices, general ledgers, sales and accounts payable journals and the sales tax returns filed by the taxpayer. Tr. p. 41; Taxpayer Ex. No. 7; Dept. Ex. No. 4.

17. During the audit period, ATI's sales invoices contained a line item that stated "tax" and taxpayer collected this amount from its customers. Taxpayer Ex. No. 2.

18. ATI did not refund any tax to its customers for the periods at issue. Tr. p. 38.

Conclusions of Law:

Issue 1

The Department audited the period of July 1, 1993 through December 31, 1996, during which it determined that the taxpayer was not engaged in the business of selling tangible personal property at retail, rather, the taxpayer was properly classified as a construction contractor and was liable for use tax on the cost price of its material and

supplies. Accordingly, the Department issued Notices of Tax Liability assessing Use tax for the audit period.

Taxpayer was classified as a construction contractor as a result of an amendment to the ROTA, effective August 20, 1993. Prior to this change in the statute, taxpayer was classified as a retailer and liable for retailers' occupation tax. Section 1 of the Retailers' Occupation Tax Act was amended effective August 20, 1993 to add the following language:

> Construction contracts for the improvement of real estate consisting of engineering, installation, and maintenance of voice, data, video, security, and all communications systems do not constitute engaging in a business of selling tangible personal property at retail within the meaning of this Act if they are sold at one specified contract price.
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> S.H.A. 35 **ILCS** 120/1 (West, 1996).

Construction contractors are required to pay tax on the cost price of the tangible personal property it converts into real estate. Lyon & Sons Co. v. Department of Revenue, 23 Ill.2d 180, 185 (1961); 86 Ill. Admin. Code ch. I, Sec. 130.1940 & 130.2075. Subsequent to the administrative hearing, the taxpayer conceded that it is a construction contractor in its post-hearing memorandum of law, furthermore, it conceded that it owes the use tax on the cost of its materials. *See*, Taxpayer Brief p. 5. The NTLs assessed use tax and was calculated on the taxpayer's cost of its materials. Dept. Ex. No. 1.

Issue 2

The taxpayer also filed a claim for credit for the same period, and it is only the claim and the penalties on the NTL that remains in dispute. During the audit period, the taxpayer, believing itself to be a retailer, filed sales and use tax returns and remitted

retailers' occupation tax ("ROT") to the Department. On these returns, it stated its gross receipts on line 1 and took a deduction for the tax it collected from its customers. It also took the discount for timely filing and paying by the due date and remitted its ROT to the Department. As a result of the Department's audit, the taxpayer learned that it was filing incorrectly and filed a claim for credit for the ROT remitted to the Department.

In denying the taxpayer's claim for credit, the Department maintained that the taxpayer over-collected tax from its customers since it charged tax on the selling price of the materials. Undisputedly, the taxpayer's sales invoices reflect a separate line item for tax charged on the goods sold to customers. *See*, Taxpayer Ex. No. 2. The tax charged on the mark-up, i.e., the difference between the selling price and the cost price is an overcollection of tax that, the Department argues must be remitted to the Department.

Taxpayer, on the other hand, contends that it is entitled to its refund because it did not truly collect tax from its customers. Rather, it contracted for "one specified contract price" as mentioned in Section 1 of the ROTA and as reflected by the contract between itself and its customers. Taxpayer Brief p. 4. Taxpayer argues that the line item of tax stated on the sales invoice is without legal effect, and must, therefore, be ignored since it is the language of the contract that should be evaluated to determine whether the taxpayer improperly collected tax from its customers. It maintains that it never intended its invoices to be amendments to the contract, since neither party signed the invoice, rather, their purpose was to collect the contract price as it was stated in the contract. Tr. p. 22. As a result, it believes the Department should be precluded from evaluating the sales invoice in determining whether the taxpayer over-collected the tax and is entitled to a refund.

With respect to claims for refund, Section 6 of the ROTA provides as follows:

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> No credit shall be allowed or refund made for any amount paid by or collected from any claimant unless it appears a) that the claimant bore the burden of such amount and has not been relieved thereof or reimbursed therefore and has not shifted such burden directly or indirectly through inclusion of such amount in the price of the tangible personal property sold by him or her in any manner whatsoever;

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35 **ILCS** 120/6

Thus, to establish that it is entitled to a refund, it is the taxpayer's burden to show that it has borne the burden of the tax.

To understand the parties' positions it is helpful to review the documentary evidence. At hearing, the taxpayer offered into evidence the following documents: one blank "standard" contract, a completed contract, and a corresponding sales invoice. The blank contract was a pre-printed standardized form that stated the words "taxes included" next to the contract price. Dept. Ex. No. 7. Taxpayer also provided one completed contract upon which the words "taxes included" had been struck over by "xxx" from a typewriter or computer. Taxpayer Ex. No. 1. No other reference is made to taxes in the language of the contract. Further, the contract states the sales price in total, it does not segregate it by material or labor. At hearing, DOE testified that all of its other contracts for the installation of telephone or voice mail systems provide for a single contract price are similar to the contract in evidence. Tr. p. 17. The sales invoice that is part of the record segregates the charges into material and labor. The sales invoice also reflects a line item that states "TAX" and a simple calculation reveals that this tax amount was 6.75%[1] of the selling price of the materials. Payments are subtracted and the tax amount is included in the resulting "TOTAL DUE" as stated on the taxpayer's invoice. The

[1] Taxpayer's business address is listed as Naperville, Illinois on its sales invoice dated 10/27/95. *See*, Taxpayer Ex. No. 2. I take administrative notice that the sales tax rate in Naperville was 6.75% in 1995. *See*, Illinois Sales Tax Rate Reference Manual.

"TOTAL DUE" on the sales invoice is equal to the amount stated on the contract. *See*, Taxpayer Ex. Nos. 1 & 2.

As previously stated, the taxpayer argues that only the language of the contract is relevant based upon its analysis of Section 1 of the ROTA. Although taxpayer suggests that this particular section be viewed in isolation, this contradicts the rules of statutory construction. Such rules require that this particular section be construed in *pari materia* with the remaining sections of the ROTA, as well as the complementary Use Tax Act. Chicago Tribune Co. v. J. Thomas Johnson, 199 Ill. App. 3d 270 (1st Dist. 1983). Thus, the taxpayer's interpretation of Section 1 of the ROTA should also be viewed in light of both the relevant sections relating to claims for credit and the overall books and records keeping requirements of the ROTA and the UTA. Section 11 of the Use Tax Act provides:

> §11. Every retailer required or authorized to collect taxes hereunder and every person using in this State tangible personal property purchased at retail from a retailer on or after effective date hereof shall keep such records, receipts, invoices and other pertinent books, documents, memoranda and papers as the Department shall require, in such form as the Department shall require. … For the purpose of administering and enforcing the provisions hereof, the Department, or any officer or employee of the Department designate, in writing, by the Director thereof, may hold investigations and hearings concerning any matters covered herein and may examine any books, papers, records, documents or memoranda of any retailer or purchaser bearing upon the sales or purchases of tangible personal property, the privilege of using which is taxed hereunder, and may require the attendance of such person or any officer or employee of such person, or of any person having knowledge of the facts, an may take testimony and require proof for its information.
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> 35 **ILCS** 105/11 (formerly, Ill. Rev. Stat. 1001, ch. 120, ¶439.11)[2]

[2] S*ee also, 35* **ILCS** 120/7 (similar record keeping requirement in ROTA); 86 Ill. Admin. Code § 130.801 as incorporated by 150.1320.

The statute and the regulations, therefore, demand that the taxpayer keep proper books and records and, in fact, specifically identify sales invoices. Further, the statute requires that the Department be allowed to inspect and audit these books and records.

In effect, the taxpayer is arguing that not only must its own sales invoices be ignored, its sales journals, general ledger and its own sales tax returns filed during the audit period must be disregarded in evaluating whether the taxpayer collected tax from its customers. The taxpayer portrays the Department's denial of the claim as overreaching, however, it is imperative to remember that the taxpayer's own books and records contradict its argument herein. Not only do the taxpayer's sales invoices reflect tax charged, its books and records have a tax collections account *and* the taxpayer took a deduction for tax collected on the sales and use tax returns it filed during the period. In the face of this overwhelming documentary evidence, i.e., the books and records and tax returns the taxpayer itself maintained throughout the audit period, I simply cannot accept its arguments at hearing.

The taxpayer accuses the Department of "wanting it both ways," i.e. finding the taxpayer collected only the one specified contract price with regards to the NTLs, yet ignoring this with regards to the claims for refund. It maintains that the Department is bound by the determination of one specified contract price and cannot find that the taxpayer collected tax from its customers. The flaws in taxpayer's argument are evident, however, in that the claim issue does not turn merely on the language of the contract but takes into account all the facts in the record. Obviously a construction contractor may handle its tax obligations incorrectly, thus, it is not inconceivable that a contractor may improperly collect tax from its customers. Moreover, it is entirely possible for a construction contractor's contract to remain silent as to the issue of taxes, while it

separately invoices the customer for tax. Taxpayer's attempt to confine the Department auditor's examination to a review of the language of a contract between the purchaser and the taxpayer is unjust since the statute demands that it be allowed an opportunity for a thorough audit.

Further, to accept the taxpayer's argument I must believe the following: ATI, believing itself a retailer, deliberately chose to absorb the full impact of its perceived ROT liability (calculated on the sales price) despite knowing that it could offset its ROT obligation with tax collected from its customers and it took the deduction on its sales and use tax returns for tax collections despite knowing that it supposedly did not collect tax. In a competitive business environment it is unlikely that a taxpayer would choose to pay more tax than was required, therefore, I cannot accept the underlying premise of taxpayer's arguments.

Given the State's broad interest in conducting a fair and thorough audit, taxpayer's proposal to disregard its own books and records is inconceivable. Surely ABC Telecommunications' own books and records are the best representation of its business activities, thus allowing the Department auditor an unfettered review of its books and records when auditing and assessing tax is the fairest approach. Taxpayer narrowly focuses on one sentence within Section 1 of the ROTA, yet clearly its approach yields a result that could not be the intent of the legislature.

Moreover, absent fraud, the taxpayer's books and records in this case should be reliable since the taxpayer has a great stake in ensuring that its own books are accurate given that this financial information serves as the source of its financial statements and its own internal accounting data is used when making important decisions, such as calculating its contract bids for projects.

The taxpayer also failed to prove that it would not be unjustly enriched if given the refund. Generally, an individual must remit the tax to be entitled to receive a refund from the Department. If not, the individual must reimburse the person who actually remitted the tax before filing a claim with the Department. 35 **ILCS** 120/6; Consolidated Distilled Products, Inc. v. Mahin, 56 Ill. 2d 110 (1974). Here, the taxpayer argues that it is not required to refund the taxes to its customer since it only collected one contract price. It further maintains that if required to refund an amount to the customer as "taxes collected," it would be entitled to return to its customer to collect the balance due under the contract. It is unclear whether taxpayer would prevail under these circumstances. In any event, the taxpayer should not prevail on its claim for refund against the Department based upon mere speculation especially since its own records and invoices show tax collected, therefore, it must refund the tax collected to its customer to be entitled to a refund from the Department.

Obviously, there is no conceivable reason why a taxpayer should be required to pay use tax upon tangible personal property and remit ROT upon the same property, and my recommendation should not be construed to affirm such. However, the taxpayer has conceded that it owes use tax on the cost of its materials which is the basis of the Notices of Tax Liability, thus, it has removed this issue from consideration. I am left only to determine the merits of taxpayer's claim for credit. In view of this and after reviewing taxpayer's books and its sales tax returns filed upon which it claimed a tax collected deduction and a collection discount of 1.75% for timely filing and remitting ROT to the Department, I can only conclude it collected tax, improperly, from its customers. Further, the statute clearly mandates that the entire amount of tax collected from its

customers represents an overcollection of tax that must be remitted to the Department. Section 3-45 of the UTA addresses this point and states in relevant part:

* * *

> If a seller collects use tax measured by receipts that are not subject to use tax, or if a seller, in collecting use tax measured by receipts that are subject to tax under this Act, collects more from the purchaser than the required amount of the use tax on the transaction, the purchaser shall have a legal right to claim a refund of that amount from the seller. If, however, that amount is not refunded to the purchaser for any reason, the seller is liable to pay that amount to the Department.

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35 **ILCS** 105/3-45

Therefore, since taxpayer collected tax, albeit improperly, from its customers during the audit period, it must pay these amounts over to the Department. Granting the taxpayer a refund without first requiring it to refund the tax to its customers would allow taxpayer a windfall. Accordingly, I am obliged to deny the taxpayer's claim for credit.

To prevail in its quest for a refund of the ROT it remitted to the Department, it must merely demonstrate what the courts have held is required of every Illinois taxpayer; it must prove that it bore the burden of the tax by first remitting the improperly collected tax to its customer. 35 **ILCS** 120/6; Consolidated Distilled Products, Inc., *supra.*

Issue 3

Finally, it must be determined whether the penalties as stated on the Notices of Tax Liability should be abated due to reasonable cause. *See,* 35 **ILCS** 735/3-3 & 3-8. While the statute does not define reasonable cause, the Department's regulation states that reasonable cause is to be determined on a case by case basis taking into account all of the facts and circumstances.[3] 86 Admin. Code ch. I, Sec. 700.400(b). Section 700.400 indicates that the most important factor is the extent to which the taxpayer made a good

[3] Section 700.400 addressing reasonable cause became effective on January 1, 1994.

faith effort to determine the correct tax liability and subsection (c) provides that a taxpayer is considered to have made a good faith effort if he uses ordinary business care and prudence. Factors which are considered in determining whether the taxpayer exercised ordinary business care and prudence are the clarity of the law and its interpretation, and the taxpayer's education, experience and knowledge. *Id*. In this case, the taxpayer did timely file its monthly returns as a retailer and remitted ROT, following what it thought was the proper procedure. Based upon all of the evidence at hearing, it is clear that the taxpayer is entitled to an abatement of penalties due to reasonable cause.

Wherefore, for the reasons stated above, it is recommended that the Tentative Denial of Claim should be finalized. Taxpayer has conceded that it owes the use tax, therefore, the NTLs should be finalized. The penalties on the NTLs should be abated due to reasonable cause.

Date: February 4, 2000

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Administrative Law Judge